Clearing Houses and Currency

No. 2

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BY

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Gentlemen:

Among students of finance generally, a strong feeling exists that the National Monetary Commission's Bill, known as the Aldrich Bill, in its amended form, more nearly met the requirements of this country with respect to monetary reform than anything that has yet been brought forth. The principal objection to the plan is, undoubtedly, an inherent public fear that the proposed central organization, with its great possibilities for concentration of power, might come under the control of one set of bankers who would use it for their own purposes. The provisions for electing the directorates of both the central organization and its branches were somewhat complicated, and there were other important features which did not meet with public approval; therefore, while there was much to be said in favor of the general principles of the

Aldrich Bill, and considerable time and money were spent in its preparation and propaganda, I think we are all convinced that it cannot become a law at the present time.

In view of these facts, why should we not turn to possible utilization of some of the banking machinery which is already at hand, with which the public is quite familiar, and to which there is no objection?

There are three functions, at least, which must be performed by some one body or bodies, before we can effectively eliminate the possibility of panics in this country. These are the massing, under an unselfish control, of the banking reserves of the country, the granting of adequately regulated power to issue notes, and the option of rediscounting good commercial paper held by the individual banks.

First: It is very important that the banking reserves of the country should be massed to some extent, at least, in order that we may derive the full benefit of the tremendous steadying power they represent. In the pyramiding of reserves, for which the present banking laws are responsible, there is an element of menace, rather than of strength, to the general situation in times of financial stress, principally because of

the self-interest which immediately manifests itself at such times among nearly thirty thousand banks.

Second: There is not another country in the world where the flow of currency is so entirely unresponsive to the demands of trade and commerce. It has been said many times, and is true, that the supply of our currency is often most redundant when we least require it, and always insufficient when we need it most. The explanation lies in the provision of the National Bank Act, whereby a bank actually ties up money in issuing notes, since it is obliged to pay a premium on the United States bonds in which it must invest part of its capital, against which notes only to the par value of the bonds deposited may be issued. Therefore, it is impossible for a national bank to advantageously assist in providing currency in times of panic, under our present laws. If, however, the power to issue notes against good commercial paper, either at face value or at a percentage of face value, was lodged with one central association, or, since that seems improbable of accomplishment, then with several associations, or through the sub-treasuries, under Federal supervision, the situation would be entirely different. I be-

lieve that the Clearing Houses could be utilized as guarantors of such commercial paper, thus providing an absolute assurance that no loss would ever occur to holders of currency so issued. This would entirely eliminate the fear of recurring money stringencies and enable us to enjoy the comfortable feeling that our currency was on a basis of elasticity whereby it would respond to such demands as might be placed upon it by the expansion and contraction of our trade and commerce.

Third: A bank with perfectly good customers' paper may become embarrassed in a period of stringency by the lack of facilities, under the present law, for converting at least a part of these assets into cash, with which to meet the demands of its depositors. It is admittedly true that this short-time merchants' paper has, in the past, under stress, proved the most dependable asset a bank can hold. At critical times, stocks and bonds can only be sold at a sacrifice, but carefully selected commercial notes can be counted upon to realize one hundred cents on the dollar, as these notes represent generally actual transactions in commodities. The great difficulty in this country under its present banking laws is, that when these periodical dis-

turbances make their appearance, the inability of our institutions to continue the performance of their natural functions, viz.: the payment of checks and the discounting of commercial paper serve to undermine the stability of the whole credit structure.

What we must seek to do, therefore, is to provide in some way for the exercise of the three functions I have mentioned. With these operative and receiving the full support of the banks, we would, in my judgment, be much less liable to financial panics in this country. We shall always have temporary depressions in trade, but these would not be accompanied by the destruction of capital, which has characterized panics of the past under our present laws.

The danger of the restriction and practical paralyzation of our domestic exchange, which was one of the prominent and disturbing features of the panic of 1907, and which added enormously to its severity, would no longer have to be feared, because through the constant availability of credit in all parts of the country for conversion into cash means, making possible the transfer of cash funds by wire by established agencies, the conditions which brought about the clogging of domestic exchange at that time

could not recur, and it would be difficult to conceive of any situation growing up which would seriously interfere with that very important operation.

Perhaps bankers who are in daily touch with financial conditions can see these defects in our system more clearly than the merchant, manufacturer and farmer, who are naturally cognizant only of results as they effect their individual interests and do not search for the causes for the existence of such deficiencies. They are only brought prominently to the attention of the layman in times of financial disturbance, and are soon forgotten; but to the banker they are forcibly presented daily by the inequality and fluctuations of the rates of loans and discounts, the movements of foreign exchange, the cost and risk of shipping currency, and in many other ways.

So much has already been said and so many plans have been proposed to cure these evils, that it would be impossible for any one to suggest an entirely new thought, or one that did not incorporate some of the features of some of the plans already presented.

I have given serious thought to this subject of monetary reform, and long ago became con-

vinced that our Clearing House system furnishes us the machinery through which, in case the country was not ready for a complete reorganization of our monetary system, a substantial measure of relief could be afforded, and that some plan should be adopted that would contemplate the use of the exceptional facilities these associations offer.

The Clearing House has become a powerful factor in the financial life of this country. In addition to its primary function of settling debits and credits, it has, through the pledging of the combined resources of the individual banks, become the great machine for strengthening and maintaining the integrity of our entire financial structure.

I have believed for a considerable time, and so expressed myself as far back as 1907, that Clearing Houses should be incorporated, and I reiterated that belief before the Pujo Committee in June of last year. It has become the order of the day that when any body of men exercise power which affects the country at large, or any great portion of the public, that power or authority, although ostensibly private, is, nevertheless, impressed with a public character. Therefore, it should be subject to gov-

ernmental regulation, irrespective of the manner in which it may have been administered in the past. And so it has seemed to me that if the Clearing House is to form the nucleus of a comprehensive currency system in this country, as some of us believe to be possible, one of the first requisites is adequate provision for incorporation. My own preference would be for a Federal incorporation law, something after the order of the National Bank Act.

The occasion in 1907 referred to, on which I first publicly advocated the incorporation of Clearing Houses, was in an address at Columbia University on "Clearing Houses and the Currency." At that time I suggested the adaptation to a more general use of Clearing House Loan Certificates, issued by the Clearing Houses in times of panic, my view being that we do not need any more fixed currency in this country, but, in the absence of flexibility, we require the means for temporary additions to the volume, which I proposed to obtain, briefly, in the following manner:

I have mentioned the necessity, in periods of active demand for money, of a medium through which the banks can convert their fixed assets into liquid or cash assets, without calling upon

borrowers for payment of their loans, and, furthermore, to place themselves in a position to assist the general situation by being able to respond to the requests of their worthy depositors for further credit. This is really the purpose of Clearing House Loan Certificates. In New York City these Clearing House Loan Certificates were issued in 1907 at a ratio of 75% of the amount of the collaterals presented by the banks, which collaterals were passed upon as to their character by a committee of five thoroughly qualified bank officers. The certificates bore interest at the rate of 6%, so that they would not remain outstanding longer than the exigencies of the occasion demanded.

My proposal at that time was to have the Clearing Houses located in the Sub-Treasury cities incorporated and prepared to do business with the United States Government. Then to have a United States Currency printed in large quantities and lodged, under proper safeguards, with each Sub-Treasury, and authorize the Treasury officials, upon prescribed application, to receive Clearing House Loan Certificates from the Associated Banks in any of these cities as collateral security for the issue of this currency to the extent of 50% of the amount of

such certificates deposited by the local association. It was my judgment that this currency should also bear interest, so that the cost of carrying it would be sufficiently heavy to cause it to be retired just as soon as it was no longer required. Such a currency would have behind it: First: The credit of the banks which take out the Clearing House Loan Certificates and their collateral as passed upon by a committee of bank officers. Second: The margin of collateral required before the Clearing Houses would issue certificates—on which not a dollar has ever been lost. Third: The fact that the Government is asked to advance only 50% on Clearing House Loan Certificates, and, Fourth: The certainty of its prompt retirement in lawful money when the emergency has passed. It is inconceivable to me how there could be any element of uncertainty or lack of security about such a currency.

That was my idea in 1907 for affording an *elementary relief* to the general situation in times of panic, and I felt it would meet the requirements until some broader plan could be devised and put into operation. I am still of the opinion that such a measure would have proved effective in the sense that it would have

adequately replaced the currency that is hoarded at such times. However, we have now the Aldrich-Vreeland Bill of 1908, under which we have formed our National Currency Associations, and while I think this measure would take care of the currency feature in case conditions such as give rise to panics should again visit us, I am of the opinion that it would be necessary to make use of Clearing House Loan Certificates as well. This law, however, expires by limitation on June 30, 1914, and unless its provisions are extended beyond that date, it leaves us but little more than a year to decide what permanent measures we are going to adopt to rectify the deficiencies of our present laws.

In a general way, I am going to take the liberty of presenting to you another thought of mine, looking to the utilization of the machinery of Clearing Houses along somewhat broader lines, with the idea that possibly through the employment of their facilities we might be able to work out a comparatively simple but effective permanent plan of monetary reform.

Granting, as we already have, that public prejudice is sufficiently strong at the present time, to discourage the hope that the creation of a Central Association, even though it be not

a bank, is possible of accomplishment, my idea is to provide by Federal law for incorporation of all Clearing Houses, and further for the incorporation of a District Association in each of the Sub-Treasury cities, to comprise as members the regularly incorporated Clearing Houses naturally contiguous to such Sub-Treasury cities respectively, these bodies to have powers and functions as hereinafter set forth.

Such a plan would provide only for banks that are now, or that may later on become, members of established Clearing Houses, and would leave a very large number of National and State banks and Trust Companies without any direct connection with these District Associations. I think it is quite important, in any proposed legislation, that all banks, organized under both National and State laws, should be placed upon as nearly an equal basis as possible. I would, therefore, favor a provision for Associate Membership of regularly incorporated Clearing Houses, which could be availed of by banks not now members of any Clearing House Association. These banks would naturally affiliate with the Clearing Houses to which they were most conveniently located. Such Associate Membership should be exclusively for the purpose of enabling these

banks and trust companies to derive the same benefits from the District Associations as regular members, but not to participate otherwise in the activities of the Clearing Houses. On the other hand, associate members should be placed on the same basis as regular members with respect to contributions of capital to the District Associations, and voice in the management of the same.

Inasmuch as these District Associations would deal principally with the Clearing Houses and to some extent with the Government, but not at all with the public, their capital should be provided by the banks themselves. Likewise their management should be decided upon principally by the banks, although the Government might reasonably reserve the right to appoint some of the executives of these District Associations.

In arriving at the basis for the election of directors, I would be distinctly in favor of each bank member of the individual Clearing Houses and of each Associate bank member, having but one vote, irrespective of its size, in whatever plan could be worked out for that purpose. This method of voting obtains in a very large majority of Clearing Houses, if not all, and is manifestly more fair and would appeal to public opin-

ion to a much greater extent than one which gave the large bank many more votes than its small competitor.

Among the functions to be lodged with these District Associations I would name two, the importance of which we have already discussed. First: These Associations should be empowered to hold part of the reserves of the Clearing House Banks in their respective districts, which districts should be clearly defined by statute. Second: They should be empowered and required to re-discount such mercantile paper as might be submitted to them by the individual Clearing Houses, with their guaranty, which would mean the joint guaranty of all the institutions comprising their membership. Such paper should be limited as to maturity and be the outgrowth of bona fide commercial transactions, as distinguished from accommodation or collateral loan paper.

To take care of the third function, that of note-issue, I would be in favor of the Government providing notes, to be held in the Sub-Treasuries under proper safeguards. The District Associations should be empowered to deposit with the Sub-Treasuries so much of the commercial paper re-discounted by them for the

individual Clearing House Associations, or, in other words, for their members, as might be necessary to meet the demands of such members for currency, and receive therefor notes to a certain percentage of the face value of the mercantile paper thus offered.

Our currency cannot be absolutely responsive to the requirements of business in this country, until some provision has been made for the practical retirement of part of the great volume of outstanding National Bank notes, which at the present time is in excess of $750,000,000.

Our National Bank currency is not only not responsive to greater demands upon it, but it is not amenable to retirement when not required, the increase or decrease in its volume depending almost entirely upon the condition of the market for the 2% bonds. The point I seek to make is, that while with this form of notes outstanding it is comparatively easy to provide for an auxiliary expansion of the currency, it is impossible to provide for the requisite contraction beyond the amount of our present outstanding currency, which includes these bank notes, and which is practically fixed.

Of course the principal difficulty involved in a satisfactory adjustment of this problem is the

2% Government bonds, the price of which is maintained solely upon the strength of the circulation privilege which they enjoy. Deprived of that, these bonds would sell below par for investment demand, which we naturally would dislike to see. My idea of handling this situation would be to abolish the present limit of monthly retirement of bank notes, viz., $9,000,000, in favor of absolute freedom in that respect. If this were done and provision also made for an asset currency, as herein suggested, I believe that it would not be very long before the latter would replace the former entirely. We would still have the bonds to dispose of satisfactorily, but it seems to me that the Government could well afford to refund these at a higher rate of interest for the public good. This could be done at a comparatively small cost, when taking into consideration the benefits that would naturally accrue to the commercial interests of the country from an efficient currency system, which would serve to keep all business on an even keel, thereby placing the income of the Government on a much more lucrative and steady basis. Furthermore, some reimbursement to the Government might reasonably be expected from profits of the District Associations, after a percentage, to be determined

upon, had been deducted therefrom as a dividend to the banks on their stockholdings in the Associations.

In order to properly control the issue of a currency such as I have mentioned, adequate provision should be made for its redemption, and for that purpose all notes issued through each District Association should be marked with the name of such Association, and it should be incumbent upon every other Association to forward all notes received by them to the different District Associations through which they were issued, say once a week, or oftener, for redemption, and I would favor any provision that would serve to place such notes on as nearly the same basis as checks, as possible, with respect to their quick redemption.

In addition to this, I would suggest a Government Board, to be composed of the Secretary of the Treasury, the Treasurer of the United States, and the Comptroller of the Currency, to meet weekly, and based upon reports received from the managers of the District Associations as to conditions in their respective districts, and upon such other information as they might be able to gather, to name the rate of discount which would apply on all loans made by the District

Associations in the interim. The ability of this Board to raise or lower the rate of discount upon paper offered to the District Associations for discount, or for the purpose of securing currency, would be an important check upon excessive note issues, and, through the Associations, gold could be attracted or repelled by the action of this Board with respect to the rates of discount, just as the great banks of continental Europe raise and lower their rates for this purpose.

It should be incumbent upon all District Associations to maintain an adequate gold reserve at all times upon issues of notes outstanding through them.

I think it is important that jurisdiction over the issue of these notes should be given to the Secretary of the Treasury, so that if any limit is placed upon the maximum amount to be issued, there can be an equitable distribution to each section, based, possibly, on the relationship which the capital and surplus of the affiliated banks of each District Association bears to the whole, or on some other plan.

The cost and risk of shipping currency would be largely obviated, as transfers of that character would be reduced to a minimum, since the local organization would meet most of the needs.

Any extraordinary demand could be taken care of through application to the District Association to deposit the amount for transfer with the Sub-Treasury which, in turn, would wire it to the Sub-Treasury in the city in which was located the District Association with which the bank due to receive the currency was affiliated.

The theory has been advanced, in an abstract way, of dividing the country into districts, in each of which an important agency would establish a department for the purpose of expeditiously collecting and remitting for checks received, payable within its district. Many clear thinkers are of the opinion that the solution of the Inland Exchange problem, which is at present in such a chaotic state throughout the country, will eventually be brought about by this means.

If, therefore, a plan such as I have outlined is practicable, then we might profitably utilize the District Associations in the collection, at par, of our country checks as well. In other words, each District Association would maintain a well-equipped Collection Department, which would collect all checks on banks within its district, received for collection from other Associations, and send for collection to other District Associations such checks as the banks in its own district should

find it desirable to deposit for that purpose. Under an arrangement of that character, it is clear that the balances only, between the District Associations, need be settled two or three times a week, though the good offices of the Sub-Treasuries.

The Sub-Treasuries of the United States are at present located in the following cities:

Boston,	New York,	Philadelphia,
Baltimore,	Cincinnati,	Chicago,
St. Louis,	New Orleans,	San Francisco.

It might appear that the plan of designating simply these cities is somewhat inequitable, since, as is quite apparent, there are no Sub-Treasury cities between Baltimore and New Orleans, and between St. Louis and San Francisco. My thought, therefore, would be to have the Government establish two or three additional Sub-Treasuries, one of which should be located in the South, and one or two more at convenient points in the West. In that way the country would, in my judgment, be pretty well covered.

An arbitrary distribution of existing Clearing Houses on a geographical basis for the purpose of securing an idea of the membership of the District Associations, based upon the present Sub-Treasury cities, indicates the following:

Boston	12	Cincinnati	27
Baltimore	17	New Orleans	46
St. Louis	30	Philadelphia	25
New York	8	Chicago	42
		San Francisco	25

Just whether a plan which contemplated the use of Clearing House machinery would have a stimulating or depressing effect on the formation of such associations is difficult to say. There are, approximately, 230 of them in the United States at the present time, a great many of which are located in small cities and are Clearing Houses in name only. These are probably for the most part operated in such a way that it is doubtful whether they could meet the conditions of incorporation, or such regulation as the Government might impose as a qualification for membership in the District Associations. But the banks so situated could nevertheless become Associate Members of adjacent Clearing Houses, and thus obtain the essential privileges.

It may be interesting to note that the banks in the Sub-Treasury cities, during the panic of 1907, had Clearing House Loan Certificates and substitutes for money outstanding to the extent of about 78% of the total of maximum amounts outstanding, which is a substantiation of the as-

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sertion that they are the principal business centres, and if selected as the locations where these District Associations might advantageously be placed, would prove adequate for the service required.

The machinery of our Clearing Houses could be easily adapted to doing business with the District Associations, so that it would be the natural thing for the bank members of each association to apply through their Clearing House to the District Association for re-discounts and currency privileges at all times, according to their needs, and rules and regulations could be promulgated to effectively reach that end.

This plan would give the country an absolutely safe asset currency, flexible in volume so as to be adapted to the needs, and under proper supervision and guarantee. We cannot afford to put anything less into the hands of our people.